WORK PROJECT

Arla Foods

Standardize and Streamline Processes to Reduce Net Working Capital

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Masters in Finance #569

Hand-in of Business Project: May 30th 2014

Hand-in of Work Project: June 13th 2014

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Context of the Business Project

The dairy industry has been consolidating due to recession in the western economies, maturing markets and the imminent removal of the EU milk quota system. Economies of scale became increasingly important to remain profitable. Amidst this market environment, Arla has climbed up the ranks of dairy companies through mergers and acquisitions and an aggressive growth strategy abroad, being currently placed in the 7th position globally. The overall milk intake is over 10,000 kg, production is spread over 12 countries, sales exceed DKK 70 B and products are sold in over 100 countries. As it is a cooperative, owners are paid via the milk price, limiting the sources and amount of capital the company can raise. In turn, this makes cash management an even more pressing issue to deal with.

The current strategy of the company tries to accommodate the globalization efforts while streamlining and centralizing operations to cut down costs, free capital and facilitate the integration of acquired companies. From that strategy, the Global Business Service Finance (GBSFI) office was created to deal with the transactional finance operations of the company. In turn, a Shared Service Center (SSC) was established in Poland to take advantage of salary arbitrage, ensuring faster, simpler and leaner transactional activities.

The tactic is suitable but the Shared Service Center is not being used to its full potential. The relocation of processes from the geographically oriented Business Groups (BGs) to the SSC followed mainly a "lift and shift" approach, resulting in a complete lack of standardized processes across functions and Business Groups. The problem was aggravated by the recent non-organic growth. The issue is an impediment to smooth post-acquisition integration of new units and creates delays in further growth ambitions, by blocking capital unnecessarily and making it harder to coordinate existing Business Groups. One area with potential for improvement was the Order-to-Cash process, which was the focus of the Business Project.

In order to deal with this challenge, the team identified best practices, mapped the current processes at Arla and performed a gap analysis. A number of issues were identified.

Adding to the fragmentation, only some BGs relocated processes to the SSC until now. Even within the BGs that were relocated, the SSC is not allowed to contact certain customers, as there are doubts about their capability to be both effective and polite during the collection process. Other related problems include recycled work, unnecessary manual work, miscommunications and poorly defined responsibilities. There is also no centralized overview of current dispute cases and risk becomes hard to manage when the company is exposed to the same client under several client numbers.

The team also identified insufficiency or inadequacy of available technology as an issue. Different IT tools are in use for the same process and there is a lack of centralized transparent information, making it difficult to leverage resources across functions and Business Groups, as it required additional training. There is also no prioritization of work and too much time is spent on rather unimportant tasks, which leaves employees little or no time to be proactive.

Finally, the lack of Global Policies and Standard Operational Procedures creates friction between the BGs and GBSFI. Incentives between the two groups are not aligned, causing miscommunication and delays in the exchange of information. Some activities are also incorrectly or inconsistently allocated, producing conflicts of interest.

It is recommended to develop Global Policies and Standard Operational Procedures to support a standardized and centralized O2C process at the SSC in Poland. The O2C process should be automated to the point where minimal manual intervention is required. Collection management can be improved by segmenting customers according to size, risk and strategic value; dispute management can be improved by identifying root causes and eradicating them when possible. In general, transparency and data availability have to be improved. Investing in integrating the IT systems and purchasing new ERP tools would support these changes and result in increased efficiency. The final recommendation concerns KPIs, as these should be shared and aligned between the Business Groups and GBSFI.

To study the impact and justify the investment, a business case was build by the team. The impact of the suggested changes results in up to DKK 6 M annual savings in direct operational costs and a reduction in Net Working Capital costs of DKK 33 M. The payback period for this investment is 2 to 3 years due to the initial investment, severance costs and recruitment and training of the new personnel at the new location.

Further Developments

Concerning specific topics of the project that I would like to have developed further or that I would have done differently, there are three areas I can identify:

- Process Mapping and Design;
- Implementation;
- Business Case.

Process Mapping and Design

Approach

Information collection and process mapping were the initial stages of the project to understand the current situation and analyse it. The team engaged in interviews with some of the stakeholders involved in the project, including transformational managers, project leaders, team leaders at GBSFI's SSC in Poland, Risk and Compliance and IT departments; attended a requirements workshop part of the Pre-Analysis phase of the project to Arla; and collected several maps, requirements and improvement suggestions from other relevant workshops provided by the company. The interviews were used to understand different problems and perspectives concerning the current process and gather improvement and implementation suggestions from the different parties. The process mapping was detailed enough to understand the process flow and responsibility split and come up with recommendations.

Regarding process design, the team studied best practices regarding Order-to-Cash management from multiple sources, reaching from consulting firms and advisory agencies to IT facilitators and banks; identified the feasible interviewees' suggestions for improvement and had access to some "desired state" process maps from senior management. With this information we performed a gap analysis, identifying current areas for improvement and how to improve them, and recommended one of the "desired state" process maps from the company as the one to aim for, as it depicted most of our suggestions.

Limitations of the Approach

The main limitation of this approach was insufficient information concerning the front-end of the process (the Business Units activities) and the consequent bias towards stakeholders at the back-end of the process (GBSFI). However, this was not a completely deliberate choice: time constraints, limited access to geographically distant business units, language barriers, current amount of workload of those business units and sensitivity of such information hindered our ability to effectively get more information on their half. The team then decided to proceed with the analysis with the available information and forgo that information.

Second, the process mapping was not detailed enough to understand the resources required and cycle time for each activity, therefore making it impossible for the team to identify the bottlenecks, estimate efficiency improvements and make more concrete recommendations.

Thirdly, the recommendations in literature disregard the context, industry, culture, organization and client relationships of a company, therefore being potentially not applicable. Furthermore, although we looked for up-to-date information, we cannot guarantee our recommendations follow the most recent trends, and since this is sensitive information there was no possibility to benchmark Arla against its competitors. Finally, due to our limited knowledge of the specificities of the current processes, the team also had limited ability to assess their validity and applicability.

Suggested Approach

It would have been prolific to interview personnel from as many business units as possible and get their opinion on the current process, possible improvements, implementation issues and work requirements. Only so would the team have had a complete and neutral view over the process and not a skewed one. In case a majority of the business units could not be contacted, therefore limiting the ability to talk about the general case, the team could at least have used one of the business units as an example to include in the analysis and extrapolate the results to other business units, mentioning the limitations of this approach.

On a second note, it would have been better for the information about the process to be more detailed, so we could have a more thorough analysis. As mentioned, information regarding resources used and cycle times would have given us the opportunity to identify bottlenecks, better estimate efficiency improvements and provide more concrete feedback and recommendations.

Implementation

Approach

Regarding implementation, since the project was still in the pre-analysis phase within Arla, the team's approach was to provide guidance using a general method to implementation. For that end, we selected Lewin's model of change – unfreeze, move, freeze – as it was a clear 3-step approach and included driving and resisting forces analysis and management, a major factor in our project.

Additionally, a number of KPIs to be implemented and coordinated between GBSFI and business units in the newly improved process were suggested, including DSO (Days Sales Outstanding), number of disputes, error rates, % of bad debt and so on. In the team's recommendations it is also mentioned that is it very important to measure these KPIs before, during and after the transition process, in order to measure the improvements achieved by the change and get strong empirical proof to convince the remaining business units to change and relocate their processes as well.

Limitations

Although Lewin's 3-step model provides a good and simple holistic view of how to accomplish the desired changes it provides little information on what should really be done at a more practical level.

Suggested Development

Although it was not the main focus of the report, it would be of value to have seen this topic further developed and I propose to do that using McKinsey's 7S model.

McKinsey's 7S model complements the 3-step approach as it addresses the factors that need to be considered in an organization to support change. These factors can be considered "hard" (easily identified and influenced by management) or "soft" (mainly influenced by culture, therefore harder and slower to influence). The hard factors are: Strategy, Structure and System; the soft factors are: Shared Values, Skills, Style and Staff.

Strategy: The strategy of the company is aligned with centralization and harmonization of processes, indeed being the initiating factor for the change we now propose. However, people seem to lack a clear understanding of the tactical aspects of that strategy, leading to diverging interpretations and the creation of different agendas. Consequently, it is possible that personal or business units' goals go against the organization's strategic objectives.

Structure: Arla currently has a divisionalized structure, with strong middle management (business unit managers), but changing the focus to the Strategic Apex (corporate office). However, the team noticed that there is a lack of cooperation between these two. There is a high degree of attrition between GBSFI and business units, and the latter do not acknowledge nor appreciate GBSFI's intention to change processes, even though GBSFI is a corporate office, therefore should in theory have power over the business units. This is in management's hands to change, and new roles and responsibilities should be defined in order to proceed with the relocation process smooth and successfully.

System: The system is concerned with the operational level. As mentioned, there is a plurality of processes in place, insufficient or inadequate technology and poorly split responsibilities. It is in the management's power to define the new process, purchase the necessary IT tools and integrate the existing ones, redefine responsibilities where conflicts of interest or inconsistencies exist and create Service Level Agreements.

Shared Values: The main challenge here is to successfully integrate the acquired companies into Arla's culture without creating disruption. As it is known, culture compatibility is often an issue in post-acquisition integration, aggravated when there are people made redundant and laid off. By promoting shared values Arla can decrease the resistance to change and the need for formal control mechanisms. However, most of the shared values should not be a problem, as Arla often merges with other dairy cooperatives.

Skills: Given their global expansion, the company profile is changing and a new skillset is necessary. The company is now very Europe centric and was used to work with established brands and mature markets. The transition is already being made with technological research centers, responsible for coming up with innovative products and solutions. Apart from that, the company needs to establish new structures to share knowledge, provide appropriate training and recruit the diverse workforce necessary for the future. Concerning the Order-to-

Cash process, the necessary skills are already in place, they are just not being applied to all business units.

Style: This factor regards the leadership behaviour within the company and the company's ability to develop talent. Arla has several talent development and leadership programs in place, from graduates to top management, and for what the team could observe managers are well regarded and respected, for which this is not an impediment to change for Arla.

Staff: This factor could be a major impediment to change in the company, as lay-offs can affect overall morale and performance and the company needs to find relevant talent that fits the company culture for the SSC. While the first factor is a problem, as was made evident to us in the case of the UK (after relocation there was a major upturn in turnover in the business unit and service levels were affected), the second factor does not seem to be a problem, as the company has been able to find appropriate candidates in Poland without any issues.

In conclusion, it is possible to see that Structure and System should be addressed by the management team, as it is within their power to influence it and should be relatively easy to change, while Strategy and Staff have to be carefully managed and properly communication put in place in order to ensure success. Shared Values, Skills and Style should not pose any resistance to this change process.

Business Case

Approach

For the business case, the team had access to a report on the CGN business unit (Consumer Germany and Netherlands), one of the company's core markets and one that had recently experienced intense M&A activity. The report consisted of an activity breakdown, number of FTEs (Full Time Employees) per activity and different scenarios regarding the centralization of activities. These scenarios specified which activities would be relocated to where and provided an estimation of the work shadowing, severance, recruitment and training costs and how many employees would be relocated and how many became redundant.

To calculate the impact at company level, the team collected information regarding salaries, severance costs and recruitment and training for the different business units. With this information, the scenario where most Order-to-Cash activities were relocated to the Shared Service Center in Poland was updated for Germany and taken as a base scenario. For other business units, since no similar report was available, the team used the same ratio of employees transferred and made redundant per unit of revenue and the local salary and severance costs to calculate the savings and payback period.

Regarding Net Working Capital, as no estimation was available, the team assumed the relocation would allow the business units to achieve their stretch target, and the resulting savings were calculated using the company's current cost of capital (WACC).

Limitations

The approach was highly based on assumptions and somewhat limited. Only salary arbitrage and related hiring and firing expenses were taken into consideration for the operational costs, and not any office space, materials or efficiency gains. Furthermore, Germany was considered a base scenario when the team has no information whether that can be considered to be true. Besides having 2 Business Units that are product oriented (and not geographically oriented), the multiplicity of processes in place makes this assumption the business case's biggest weakness. The Net Working Capital calculations were also based on assumptions, although moderate, as the business units stretch targets are based on the current process and there is a huge margin for improvement, therefore the result is more likely to be deflated rather than inflated.

Suggested Approach

It would be interesting and much more accurate to develop the same kind of report there was for CGN for each business unit, breaking down processes into FTEs. That would give us an accurate number of people to be relocated or fired, which combined with country salary and severance costs would give us a better approximation of the correct figure.

Combined with the first suggestion of mapping and measuring current cycle times and resources, and doing the same for the newly designed process, we could calculate how many people would become redundant and how the process would be improved, not only in terms of cost but also in terms of speed and quality.

Reflection on Learning

The main focus of the project was business process reengineering, and not directly finance as the subject of my previous education. However, since it was set in a financial context (accounts receivable department / Order-to-Cash process), the financial knowledge acquired during the masters program proved very useful to understand the problem and the context from an early stage and have more in-depth discussions with the stakeholders during the interviews. This has helped us identify and solve the problem early, quickly and effectively. The subjects of Financial Reporting, Corporate Finance and Investments were the most useful, as the team had several discussions concerning Balanced Scorecard, KPIs, the Cash conversion cycle, how to build the Business Case and which value metrics to include to justify the investment.

But the most important knowledge learnt and applied was Project Management. By adopting consistent project management methodology, the team was able to develop effective plans at the beginning of the project, define the correct scope according to the clients' requirements (clients here being both CBS and Arla Foods) and minimize scope changes by committing to realistic objectives and managing stakeholders expectations. We recognized early that cost, quality and time management are inseparable, focused on deliverables and eliminated non-productive meetings. Progress was constantly measured, stakeholders were provided with appropriate, updated and timely information, and recognition for success whenever a target was met was shared with the entire project team and direct stakeholders involved. This was crucial for the project's success.

As for new knowledge, apart from all the food and dairy industry knowledge and company related knowledge, a substantial amount of operational knowledge was gained during this project. From process mapping to analysis and design I have came into contact with operational performance objectives, outsourcing and offshoring decisions, capacity management, Lean, Six Sigma, modularization, swim lane charts and Blueprints. New tools on how to depict and evaluate a process include the process Blueprints and the Polar Diagram.

A second area where I obtained new knowledge from this project was organizational behaviour. It has helped us understand the organizational influences on the project, mechanisms to promote change and driving forces. We have studied and applied methods I was not familiar with before, such as Mintzberg's organizational theories to study the structure and coordination mechanisms in place, performed stakeholder mapping and analysis to understand the driving forces and how to deal with them, and recommended Kurt Lewin's model of change (unfreeze, move, freeze) to implement the project. For the Work Project I also used a new tool: McKinsey's 7S model.

My key differentiating strengths in this project were previous knowledge of project management, some knowledge of operations management, extensive experience with group work and soft skills. The ability to work and lead effectively in a team and the calm and logic necessary to perform under pressure and deal with important decisions, interviews and presentations gave me a pivotal role within the team in this project. Moreover, the flexibility to adapt to different roles when necessary and the easiness to communicate with different cultures in different settings ensured that a healthy productive relationship was maintained with every member of the group.

My main weaknesses in this project were the unwillingness to check on others' progress and therefore inability to delegate tasks appropriately, and not setting up ambitious enough targets. There was room for improvement in the report that didn't realise because of these weaknesses. I am planning to be more assertive and sure of myself in the next projects and ask for information and feedback more often, not only using it as a tool for progress control but also to stimulate discussion and motivate my colleagues on achieving quick wins.

Looking back, I now see that we should have pushed the company harder to give us the data we asked sooner and get us access to different parts of the organization we did not have. The interviews with the different stakeholders and the field trip to the Shared Service Center in Poland provided the team with the most value and insights to write the report. For the company the new Process Design and the Business Case gave them the most value, although some value might have been left out in the implementation and the business case because of time and information constraints.

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Appendix

Appendix 1 – Global Dairy Companies

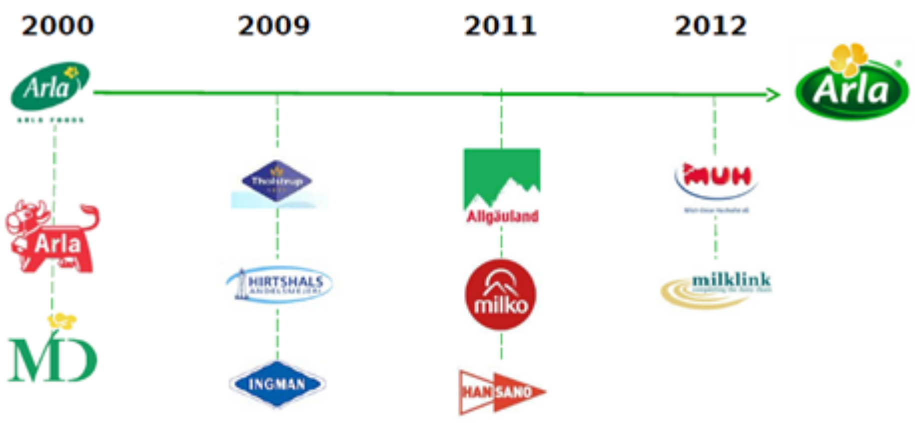
Figure 1: Global dairy top-20, 2013

#	Last year	Company	Country of headquarters	Dairy turnover, 2012 (USD billion)	Dairy turnover, 2012 (EUR billion)
1	1	Nestlé	Switzerland	30.1	23.4
2	2	Danone	France	19.4	15.1
3	3	Lactalis	France	18.0	14.0
4	4	Fonterra	New Zealand	16.0	12.5
5	5	FrieslandCampina	Netherlands	13.5	10.5
6	6	Dairy Farmers of America	US	12.1	9.4
7	8	Arla Foods	Denmark/Sweden	10.8	8.4
8	7	Dean Foods	US	8.8	6.9
9	12	Saputo	Canada	8.4	6.5
10	10	Meiji	Japan	7.7	6.0
11	11	Unilever*	Netherlands/UK	7.5	5.8
12	15	Yili	China	6.5	5.1
13	--	Morinaga	Japan	5.8	4.5
14	14	Sodiaal*	France	5.8	4.5
15	16	Mengniu	China	5.7	4.5
16	9	Kraft Foods	US	5.7	4.4
17	13	DMK	Germany	5.7	4.4
18	17	Bongrain	France	5.3	4.1
19	19	Schreiber Foods*	US	4.5	3.5
20	18	Müller*	Germany	4.2	3.3

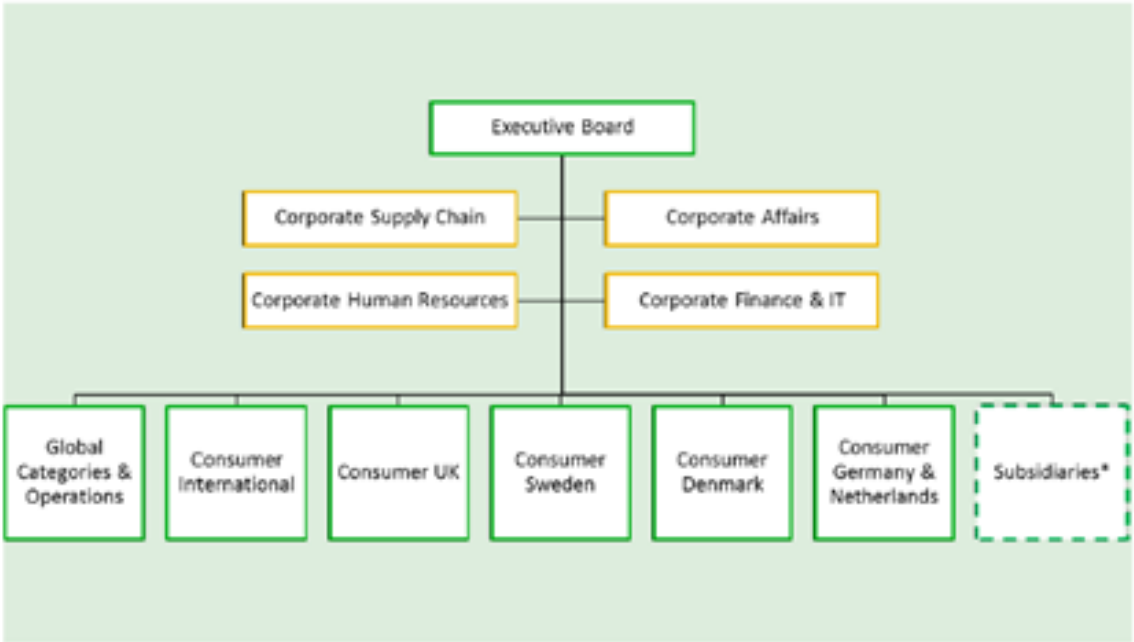
*Estimate

Note: Turnover data are dairy sales only, based on 2012 financials and M&A transactions completed between 1 January and 15 June 2013; pending mergers and acquisitions that are not included in the dairy sales are the merger of 3A and Sodiaal, and Yashili's acquisition by Mengniu

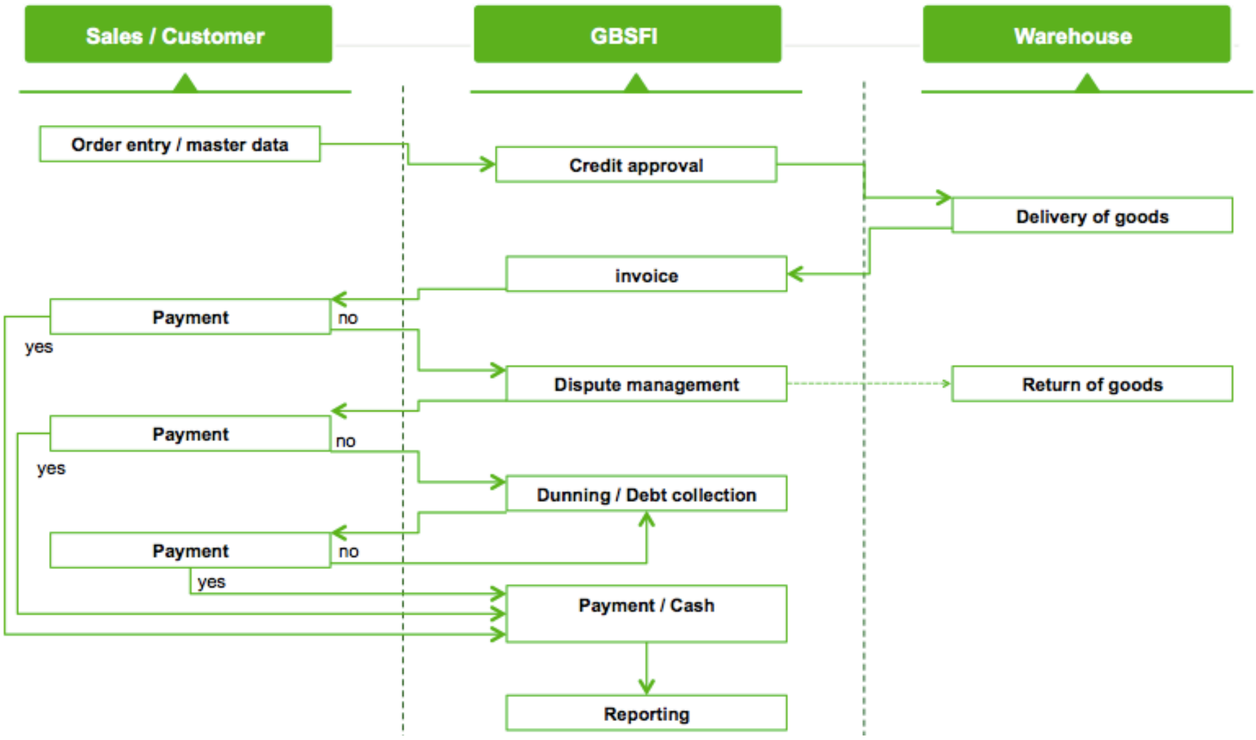
Appendix 2 – Arla's Main Mergers and Acquisitions from 2000-Present



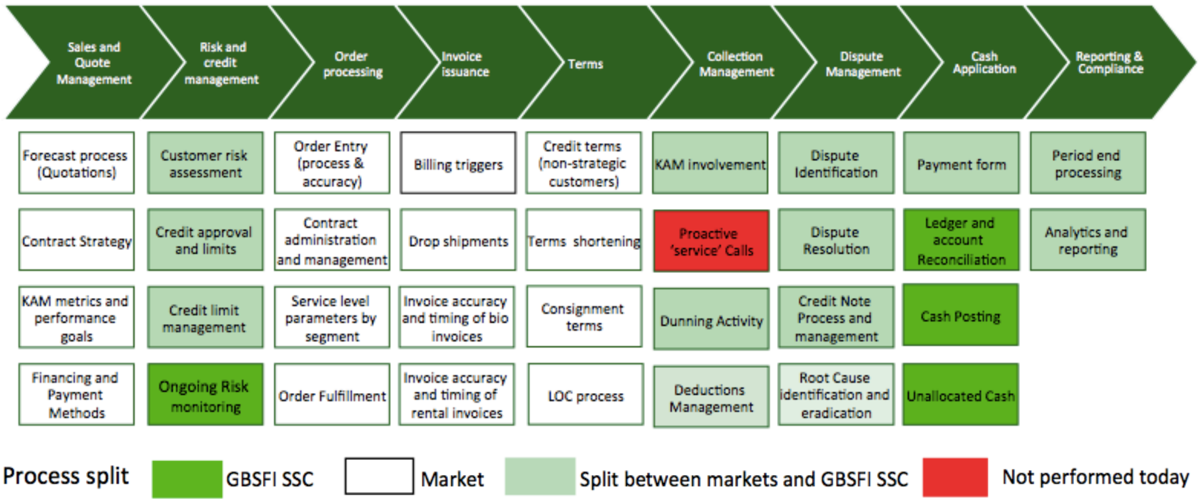
Appendix 3 – Arla's Organizational Chart



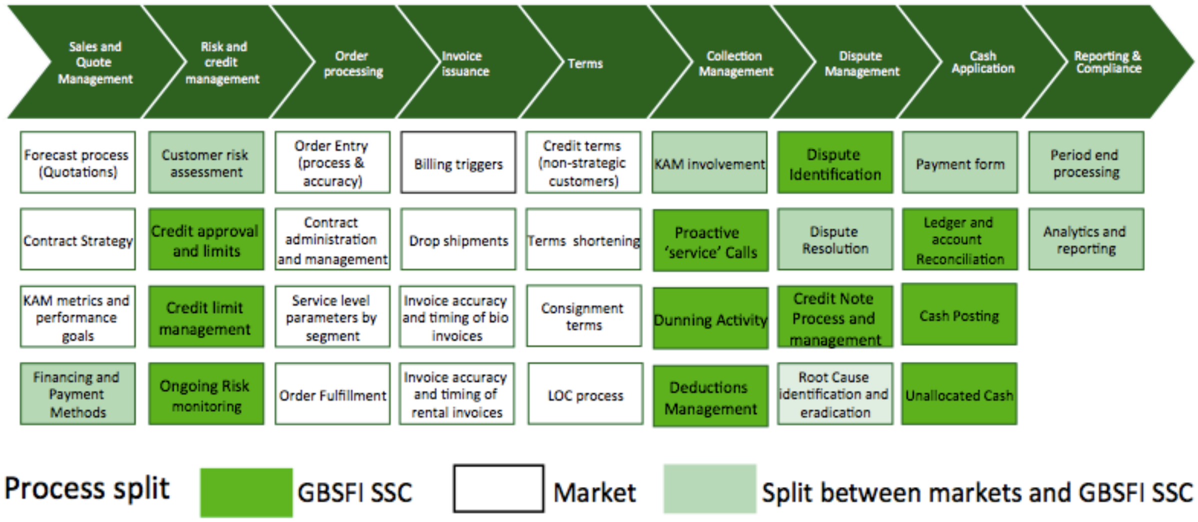
Appendix 4 – Order-to-Cash Workflow Diagram



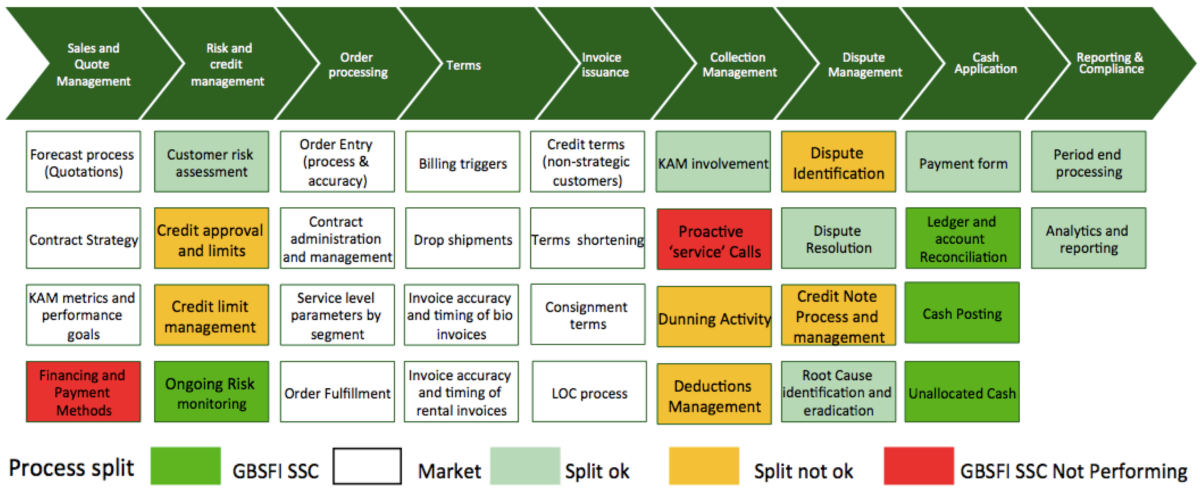
Appendix 5 – Current O2C Process Flow Chart with Responsibility Split



Appendix 6 – Desired O2C Process Flow Chart with Responsibility Split



Appendix 7 – Gap Analysis



Appendix 8 – Business Case for CGN

Consumer Germany and Netherlands (CGN)	CGN
IMPACT ON PERSONNEL COSTS	
Relocation from Local CGN office to SSC, Gdansk (FTEs)	5.3
Local annual salary (DKK)	296,235
Severance (paid only once, upon leaving local BU) (DKK)	500,000
Hiring (paid only once, polish cost of recruitment) (DKK)	8,154
Polish annual salary (DKK)	115,000
Y1 Cash Flow (DKK)	(1,726,130)
Y2 Cash Flow (DKK)	956,923
Y3 Cash Flow (DKK)	956,923
Accumulated savings at the end of Y3	**187,716**

Appendix 9 – Business Case for all Business Units

ALL BUSINESS GROUPS	CUK	CSE	CFI	CDK	CGN	CIN	AFI	GCO	BGs Total
Arla Revenue from BG (mln DKK)	19,217	11,592	2,677	6,569	12,528	5,397	2,392	6,712	67,084
Weight	29%	17%	4%	10%	19%	8%	4%	10%	100%
IMPACT ON PERSONNEL COSTS									
Local BG to Gdansk relocation (FTE)	7.7	4.5	1.1	2.6	5.3	2.1	1.1	2.6	26.4
Local annual salary (DKK)	296,235	451,000	244,800	440,000	296,235	296,235	440,000	440,000	
Severance (paid only once, upon leaving local BG) (DKK)	500,000	902,000	195,840	704,000	500,000	500,000	352,000	176,000	
Hiring (paid only once, polish cost of recruitment) (DKK)	8,154	8,154	8,154	8,154	8,154	8,154	8,154	8,154	
Polish annual salary (DKK)	115,000	115,000	115,000	115,000	115,000	115,000	115,000	115,000	
Y1 Cash Flow (DKK)	(2,502,889)	(2,576,803)	(78,349)	(1,022,087)	(1,726,130)	(690,452)	(37,123)	371,833	(8,261,998)
Y2 Cash Flow (DKK)	1,387,538	1,507,968	137,069	858,000	956,923	382,769	343,200	858,000	6,431,468
Y3 Cash Flow (DKK)	1,387,538	1,507,968	137,069	858,000	956,923	382,769	343,200	858,000	6,431,468
Accumulated Cash Flow at the end of Y3	**272,188**	**439,133**	**195,789**	**693,913**	**187,716**	**75,086**	**649,277**	**2,087,833**	**4,600,937**

Sources: CGN feasibility study, 2013 Annual Report, CGN business case Excel, other Arla documents